

# INTERMEDIATE (IPC) COURSE

## STUDY MATERIAL

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**PAPER : 3**

### **COST ACCOUNTING AND FINANCIAL MANAGEMENT**

**Part – 2 : Financial Management**

**MODULE – 1**



**BOARD OF STUDIES  
THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA**

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## A WORD ABOUT STUDY MATERIAL

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Financial Management has acquired a critical significance now-a-days, due to liberalization, privatization and globalization. The study of this important subject opens new opportunities for Chartered Accountancy students. Therefore, students need to know the principles and practices of Financial Management and how these may be applied to any business entity.

This study material provides the basic concepts, theories and techniques relating to Financial Management and deals with conceptual theoretical framework. It has been designed having regard to the distance learning students. The students are expected to cover the entire syllabus. The main features of this study material are as under:

- The entire syllabus has been divided into seven chapters.
- The chapters have been grouped into two modules
  - ◆ **Module-1 consisting of four chapters namely:**
    - Chapter-1: Scope and Objectives of Financial Management
    - Chapter-2: Time Value of Money
    - Chapter-3: Financial Analysis and Planning
    - Chapter-4: Financing Decisions
  - ◆ **Module-2 consisting three chapters namely:**
    - Chapter-5: Types of Financing
    - Chapter-6: Investment Decisions
    - Chapter-7: Management of Working Capital
- Each chapter begins with the learning objectives. The learning objectives would enable you to understand the sequence of various aspects dealt within the chapter before going into the details so that you know the direction of your studies.
- In each chapter, an overview has been given just after the learning objectives. This overview provides a preview of the entire chapter and its relevance in the present context.
- Each chapter has been covered in a step-by-step approach. The text has been explained, where appropriate, through illustrations and practical problems. You should go through the chapter carefully ensuring that you understand the topic.

- In this revised edition, chapter 1,2,3,4 & 6 have been revised to make it more student friendly.
- In this study material the traditional format of the Financial Statements (i.e. Balance Sheet, Profit & loss A/c/ Income Statement) has been used for simplicity of understanding. However, students may refer the study material of Accounting/ Advanced Accounting of Intermediate (IPC) level for the appropriate format.

# STUDY TIPS AND EXAMINATION TECHNIQUE

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The aim of this section is to provide general guidance as to how to study for your examinations. The guidance given herein is supplementary to the manner of study followed by you and is intended to improve your existing technique, but aims to give ideas on how to improve your existing study techniques, as it is essential that you adopt methods and techniques with which you feel comfortable.

Passing exams is partly a matter of intellectual ability, but however accomplished you are in that respect you can improve your chances significantly by the use of appropriate study and revision techniques. In this section we briefly outline some tips for effective study during the earlier stages.

## **Know your Syllabus**

- Go through the syllabus carefully.
- Volume I has been divided in seven chapters and units based on syllabus.
- Main topics are as under:
  - Scope and Objectives of Financial Management
  - Time Value Of Money
  - Financial Analysis and Planning
  - Financing Decisions
  - Types of Financing
  - Investment Decisions
  - Management of Working Capital
- Understand the linkages between chapters at macro-level.

## **Plan your Study**

- Make a study plan covering the entire syllabus and then decide how much time you can allocate to the subject on daily/weekly basis.
- Allocation of time must be done keeping in view your office commitments as well as social needs and personal hobbies.

- Maintain the time balance amongst various subjects such as purely descriptive type and numerical-based papers. Allocate time in such a manner that your interest is well sustained and you are able to score well in the final examination as well.
- Always assess your preparation periodically, say, on monthly basis. If necessary, revise your plan and allocate more time for the subject in which you feel deficient.

### **Preparing Study Strategy**

- Read, understand and assimilate each chapter.
- First of all, have an overview of the chapter to understand the broad contents and sequence of various sub-topics.
- Do the introspection while going through the chapter and ask various questions to yourself.
- Read each chapter slowly to ensure that you understand and assimilate the main concept. If need be, read once again with concentration and then try to attempt exercise at the end of the chapter or given in the Practice Manual.
- Recapitulate the main concept after going through each chapter by way of brief notes.
- Prepare notes in the manner you feel comfortable covering all key points. Use mnemonic form e.g. C V P denoting cost, valuation and price.
- One may use highlighter/underlining the significant points or writing down in the margin.
- The fact that how well you have understood the topic is your ability to attempt the questions given in the exercises as well as in the practice manual. Make a serious attempt at producing your own answers but at this stage do not be much concern about attempting the questions in examination based conditions. In particular, at initial stages, it is more important to understand and absorb the material thoroughly rather than to observe the time limits that would apply in the actual examination conditions.
- Always try to attempt the past year examination question paper under examination conditions.
- Revision of material should never be selective in any case. Because broad coverage of the syllabus is more important than preparing 2-3 chapters exhaustively.
- Read through the text along with notes carefully. Try to remember the definition and important formulae.

### **Examination Technique**

- Reach examination hall well in time.
- Plan your time so that equal time is awarded for each mark. Keep sometime for revision as well.
- Always attempt to do all questions. Remember that six average answers fetch more marks than five best answers. Therefore, it is important that you must finish each question within allocated time.
- Read the question carefully more than once before starting the answer to understand very clearly as to what is required by the paper-setter.
- Always be concise and write to the point and do not try to fill pages unnecessarily.
- In case a question is not clear, you may state your assumptions and then answer the question.
- While writing answers in respect of essay-type questions, try to make sub-readings so that it catches the examiner's eye. In case of case-study, be very precise and write your conclusion in a clear manner.
- Reference to standards, guidance notes, section of various legislation, etc be done in a clear-cut manner.
- Revise your answers carefully underline important points before leaving the examination hall.

*Happy Reading and Best Wishes!*



# SYLLABUS

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## PAPER – 3 : COST ACCOUNTING AND FINANCIAL MANAGEMENT

*(One paper — Three hours – 100 Marks)*

Level of Knowledge: Working knowledge

### PART – II : FINANCIAL MANAGEMENT (50 MARKS)

#### Objectives:

- (a) To develop ability to analyse and interpret various tools of financial analysis and planning,
- (b) To gain knowledge of management and financing of working capital,
- (c) To understand concepts relating to financing and investment decisions, and
- (d) To be able to solve simple cases.

#### Contents

#### 1. Scope and Objectives of Financial Management

- (a) Meaning, Importance and Objectives
- (b) Conflicts in profit versus value maximisation principle
- (c) Role of Chief Financial Officer.

#### 2. Time Value of Money

Compounding and Discounting techniques— Concepts of Annuity and Perpetuity

#### 3. Financial Analysis and Planning

- (a) Ratio Analysis for performance evaluation and financial health
- (b) Application of Ratio Analysis in decision making
- (c) Analysis of Cash Flow Statement.

#### 4. Financing Decisions

- (a) Cost of Capital — Weighted average cost of capital and Marginal cost of capital
- (b) Capital Structure decisions — Capital structure patterns, Designing optimum capital structure, Constraints, Various capital structure theories



- (c) Business Risk and Financial Risk — Operating and financial leverage, Trading on Equity.

#### **5. Types of Financing**

- (a) Different sources of finance
- (b) Project financing — Intermediate and long term financing
- (c) Negotiating term loans with banks and financial institutions and appraisal thereof
- (d) Introduction to lease financing
- (e) Venture capital finance.

#### **6. Investment Decisions**

- (a) Purpose, Objective, Process
- (b) Understanding different types of projects
- (c) Techniques of Decision making: Non-discounted and Discounted Cash flow Approaches — Payback Period method, Accounting Rate of Return, Net Present Value, Internal Rate of Return, Modified Internal Rate of Return, Discounted Payback Period and Profitability Index
- (d) Ranking of competing projects, Ranking of projects with unequal lives.

#### **7. Management of Working Capital**

- (a) Working capital policies
- (b) Funds flow analysis
- (c) Inventory management
- (d) Receivables management
- (e) Payables management
- (f) Management of cash and marketable securities
- (g) Financing of working capital.

# CONTENTS

---

## **MODULE – 1**

Chapter 1 – Scope and Objectives of Financial Management

Chapter 2 – Time Value of Money

Chapter 3 – Financial Analysis and Planning

Chapter 4 – Financing Decisions

Appendix

## **MODULE – 2**

Chapter 5 – Types of Financing

Chapter 6 – Investment Decisions

Chapter 7 – Management of Working Capital

Appendix

# DETAILED CONTENTS: MODULE – 1

---

## CHAPTER 1 – SCOPE AND OBJECTIVES OF FINANCIAL MANAGEMENT

1.1	Introduction .....	1.1
1.2	Meaning of Financial Management .....	1.2
1.3	Evolution of Financial Management .....	1.5
1.4	Importance of Financial Management .....	1.6
1.5	Scope of Financial Management .....	1.6
1.6	Objectives of Financial Management .....	1.8
1.7	Conflicts in Profit versus Value Maximisation Principle .....	1.12
1.8	Role of Chief Financial Officer (CFO) .....	1.13
1.9	Relationship of Financial Management with Related Disciplines .....	1.16
	Summary .....	1.18

## CHAPTER 2 – TIME VALUE OF MONEY

2.1.	Concept of Time Value of Money .....	2.1
2.2	Reasons Why Money in the Future is Worth Less Than Similar Money Today .....	2.2
2.3	Compounding and Discount .....	2.2
2.4	Simple Interest & Compound Interest .....	2.3
2.5	Effective Rate of Interest (EIR) .....	2.7
2.6	Present Value .....	2.8
2.7	Annuity .....	2.10
2.8	Loan Amortisation & Capital Recovery .....	2.13
2.9	Perpetuity .....	2.14
2.10	Sinking Fund .....	2.16
	Summary .....	2.18

## **CHAPTER 3 – FINANCIAL ANALYSIS AND PLANNING**

### **UNIT-I APPLICATION OF RATIO ANALYSIS FOR PERFORMANCE EVALUATION, FINANCIAL HEALTH AND DECISION MAKING**

3.1	Introduction .....	3.1
3.2	Ratio and Ratio Analysis .....	3.2
3.3	Types of Ratios .....	3.3
3.4	Application of Ratio Analysis in Financial Decision Making.....	3.20
3.5	Limitations of Financial Ratios .....	3.22
3.6	Summary of Ratios .....	3.23

### **UNIT II : CASH FLOW AND FUNDS FLOW ANALYSIS**

3.7	Introduction .....	3.47
3.8	Utility of Cash Flow Analysis .....	3.47
3.9	Limitations of Cash Flow Analysis .....	3.48
3.10	AS 3 (Revised) and Cash Flow Statement .....	3.48
3.11	Definitions .....	3.49
3.12	Cash and Cash Equivalents .....	3.49
3.13	Presentation of Cash Flow Statement.....	3.49
3.14	Procedure in Preparation of Cash Flow Statement .....	3.53
3.15	Funds Flow Analysis .....	3.65
	Summary.....	3.80

## **CHAPTER 4 – FINANCING DECISIONS**

### **UNIT I : COST OF CAPITAL**

4.1	Introduction .....	4.1
4.2	The Cost of Capital.....	4.2
4.3	Significance of the Cost of Capital .....	4.3
4.4	Determination of the Cost of Capital .....	4.3
4.5	Cost of Long Term Debt.....	4.4
4.6	Cost of Preference share capital .....	4.9

4.7	Cost of Equity Share Capital .....	4.11
4.8	Cost of Retained Earnings.....	4.17
4.9	Weighted Average Cost of Capital (WACC).....	4.19
4.10	Marginal Cost of Capital .....	4.23
4.11	Conclusion .....	4.29
<b>UNIT II : CAPITAL STRUCTURE DECISIONS</b>		
4.12	Meaning of Capital Structure .....	4.30
4.13	Designing Capital Structure.....	4.31
4.14	Key Concepts for Designing Optimal Structure .....	4.32
4.15	Optimal Capital Structure .....	4.34
4.16	EBIT-EPS Analysis.....	4.34
4.17	Cost of Capital, Capital Structure and Market Price of Share.....	4.45
4.18	Capital Structure Theories.....	4.46
4.19	Over Capitalisation and Under Capitalisation.....	4.59
<b>UNIT III : BUSINESS RISK AND FINANCIAL RISK</b>		
4.20	Introduction .....	4.61
4.21	Debt versus Equity Financing .....	4.62
4.22	Meaning of Types of Leverage .....	4.63
	Summary.....	4.76
<b>APPENDIX</b>		
	Financial Tables .....	1 – 8

# 1

## Scope and Objectives of Financial Management

### Learning Objectives

After studying this chapter you will be able to:

- Define Financial Management.
- Know the objectives, scope and how it has evolved over a period of time.
- Focus on Profit Maximization vis-à-vis Wealth Maximization.
- Outline the role of Chief Financial Officer in light of growing needs of a modern organization.
- Emphasis on relationship between Financial Management with accounting and other related fields.

### Overview

This chapter introduces you to the area of Financial Management. It discusses the evolution, importance, scope and objectives of Financial Management and how this area is inter-related with other subject areas. This chapter is of utmost importance as it deals with the fundamentals of Financial Management. Without a clear understanding of the fundamentals the remainder of the chapters will not be easy to grasp. Therefore, knowledge of the background, the environment to which this paper relates, is important as it helps to put everything learnt later into appropriate perspective.

### 1.1 Introduction

We will like to explain Financial Management by giving a very simple scenario. For the purpose of starting any new business/venture, an entrepreneur goes through the following stages of decision making:-

Stage 1	Stage 2	Stage 3	Stage 4
Decide which assets (premises,	Determining what is total investment (since assets cost	Apart from buying assets the entrepreneur would also need to determine	The next stage is to decide what all sources, does the entrepreneur need to tap

machinery, equipment etc) to buy.	money) required for buying assets.	how much cash he would need to run the daily operations (payment for raw material, salaries, wages etc.). In other words this is also defined as Working Capital requirement.	to finance the total investment (assets and working capital). The sources could be Share Capital (Including Entrepreneur's own funds) or Borrowing from Banks or Investment from Financial Institutions etc.
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While deciding how much to take from each source, the entrepreneur would keep in mind the cost of capital for each source (Interest/Dividend etc.). As an entrepreneur he would like to keep the cost of capital low.

Thus, financial management is concerned with efficient acquisition (financing) and allocation (investment in assets, working capital etc) of funds with an objective to make profit (dividend) for owners.

In other words, focus of financial management is to address three major financial decision areas namely, investment, financing and dividend decisions.

## 1.2 Meaning of Financial Management

Financial management is that managerial activity which is concerned with planning and controlling of the firm's financial resources. In other words it is concerned with acquiring, financing and managing assets to accomplish the overall goal of a business enterprise (mainly to maximise the shareholder's wealth).

In today's world where positive cash flow is more important than book profit, Financial Management can also be defined as planning for the future of a business enterprise to ensure a positive cash flow. Some experts also refer to financial management as the science of money management.

*"Financial Management comprises the forecasting, planning, organizing, directing, co-ordinating and controlling of all activities relating to acquisition and application of the financial resources of an undertaking in keeping with its financial objective." Raymond Chambers*

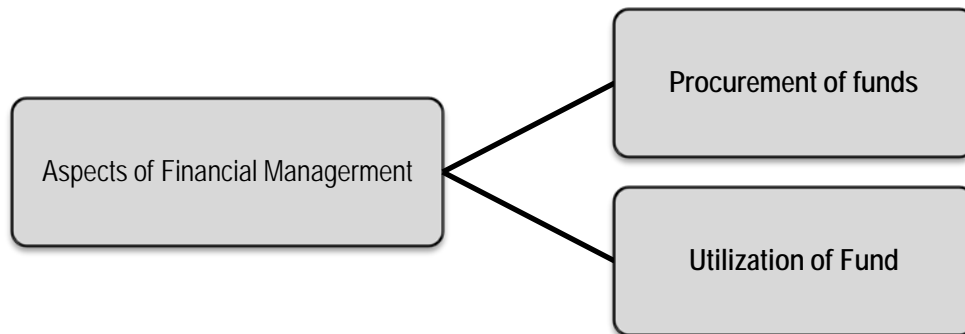
Another very elaborate definition given by Phillippatus is

*"Financial Management is concerned with the managerial decisions that result in the acquisition and financing of short term and long term credits for the firm."*

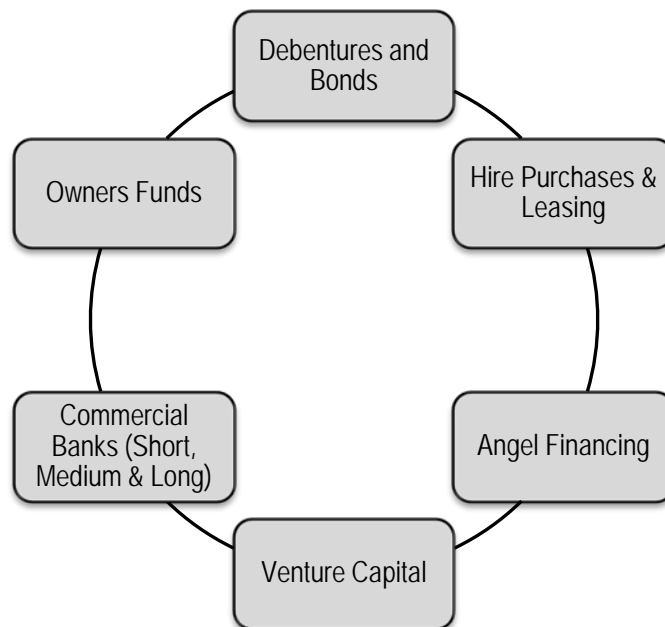
As such it deals with the situations that require selection of specific assets (or combination of assets), the selection of specific problem of size and growth of an enterprise. The analysis of these decisions is based on the expected inflows and outflows of funds and their effect on managerial objectives.

There are two basic aspects of financial management viz., procurement of funds and an

effective use of these funds to achieve business objectives.



**1.2.1 Procurement of Funds:** Since funds can be obtained from different sources therefore their procurement is always considered as a complex problem by business concerns. Some of the sources for funds for a business enterprise are:-



In a global competitive scenario it is not enough to depend on the available ways of raising finance but resource mobilization has to be undertaken through innovative ways or financial products which may meet the needs of investors. We are constantly seeing new and creative sources of funds which are helping the modern businesses to grow faster. For example trading in Carbon Credits is turning out to be another source of funding.

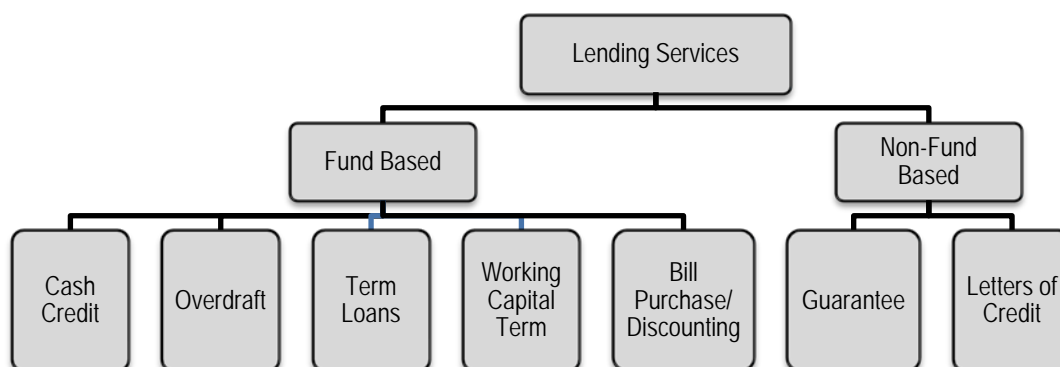
Funds procured from different sources have different characteristics in terms of risk, cost and control. The cost of funds should be at the minimum level for that a proper balancing of risk and control factors must be carried out.



Another key consideration in choosing the source of new business finance is to strike a balance between equity and debt to ensure the funding structure suits the business.

Let us discuss some of the sources of funds:

- (a) **Equity:** The funds raised by the issue of equity shares are the best from the risk point of view for the firm, since there is no question of repayment of equity capital except when the firm is under liquidation. From the cost point of view, however, equity capital is usually the most expensive source of funds. This is because the dividend expectations of shareholders are normally higher than prevalent interest rate and also because dividends are an appropriation of profit, not allowed as an expense under the Income Tax Act. Also the issue of new shares to public may dilute the control of the existing shareholders.
- (b) **Debentures:** Debentures as a source of funds are comparatively cheaper than the shares because of their tax advantage. The interest the company pays on a debenture is free of tax, unlike a dividend payment which is made from the taxed profits. However, even when times are hard, interest on debenture loans must be paid whereas dividends need not be. However, debentures entail a high degree of risk since they have to be repaid as per the terms of agreement. Also, the interest payment has to be made whether or not the company makes profits.
- (c) **Funding from Banks:** Commercial Banks play an important role in funding of the business enterprises. Apart from supporting businesses in their routine activities (deposits, payments etc) they play an important role in meeting the long term and short term needs of a business enterprise. Different lending services provided by Commercial Banks are depicted as follows:-



- (d) **International Funding:** Funding today is not limited to domestic market. With liberalization and globalization a business enterprise has options to raise capital from International markets also. Foreign Direct Investment (FDI) and Foreign Institutional Investors (FII) are two major routes for raising funds from foreign sources besides ADR's (American depository receipts) and GDR's (Global depository receipts). Obviously, the mechanism of procurement of funds has to be modified in the light of the requirements of foreign investors.

**1.2.2 Effective Utilisation of Funds:** The finance manager is also responsible for effective utilisation of funds. He has to point out situations where the funds are being kept idle or where proper use of funds is not being made. All the funds are procured at a certain cost and after entailing a certain amount of risk. If these funds are not utilised in the manner so that they generate an income higher than the cost of procuring them, there is no point in running the business. Hence, it is crucial to employ the funds properly and profitably. Some of the aspects of funds utilization are:-

- (a) **Utilization for Fixed Assets:** The funds are to be invested in the manner so that the company can produce at its optimum level without endangering its financial solvency. For this, the finance manager would be required to possess sound knowledge of techniques of capital budgeting.

*Capital budgeting (or investment appraisal) is the planning process used to determine whether a firm's long term investments such as new machinery, replacement machinery, new plants, new products, and research development projects would provide the desired return (profit).*

- (b) **Utilization for Working Capital:** The finance manager must also keep in view the need for adequate working capital and ensure that while the firms enjoy an optimum level of working capital they do not keep too much funds blocked in inventories, book debts, cash etc.

### 1.3 Evolution of Financial Management

Financial management evolved gradually over the past 50 years. The evolution of financial management is divided into three phases. Financial Management evolved as a separate field of study at the beginning of the century. The three stages of its evolution are:

**The Traditional Phase:** During this phase, financial management was considered necessary only during occasional events such as takeovers, mergers, expansion, liquidation, etc. Also, when taking financial decisions in the organisation, the needs of outsiders (investment bankers, people who lend money to the business and other such people) to the business was kept in mind.

**The Transitional Phase:** During this phase, the day-to-day problems that financial managers faced were given importance. The general problems related to funds analysis, planning and control were given more attention in this phase.

**The Modern Phase:** Modern phase is still going on. The scope of financial management has greatly increased now. It is important to carry out financial analysis for a company. This analysis helps in decision making. During this phase, many theories have been developed regarding efficient markets, capital budgeting, option pricing, valuation models and also in several other important fields in financial management.

## 1.4 Importance of Financial Management

Importance of Financial Management cannot be over-emphasized. It is, indeed, the key to successful business operations. Without proper administration of finance, no business enterprise can reach its full potentials for growth and success. Money is to an enterprise, what oil is to an engine.

Financial management is all about planning investment, funding the investment, monitoring expenses against budget and managing gains from the investments. Financial management means management of all matters related to an organization's finances.

The best way to demonstrate the importance of good financial management is to describe some of the tasks that it involves:-

- Taking care not to over-invest in fixed assets
- Balancing cash-outflow with cash-inflows
- Ensuring that there is a sufficient level of short-term working capital
- Setting sales revenue targets that will deliver growth
- Increasing gross profit by setting the correct pricing for products or services
- Controlling the level of general and administrative expenses by finding more cost-efficient ways of running the day-to-day business operations, and
- Tax planning that will minimize the taxes a business has to pay.

Let us understand this better by taking an example of a company, Cotton Textiles Limited. The company earns money by selling textiles. Let us assume that it earns ₹ 10 lakhs every month. This is known as revenue. A company has many expenses. Some of the major expenses of the company can be listed as wages to workers, raw materials for making the textile, electricity and water bills and purchase and repair of machines that are used to manufacture the textile.

All these expenses are paid out of the revenues. If the revenues are more than the expenses, then the company will make profit. But, if the expenses are more than revenues, then it will face losses. If it continues like that, eventually, it will lose all its assets. In other words it will lose its property and all that it owns. In that case, even the workers may be asked to leave the company. To avoid this situation, the company has to manage the cash inflows (cash coming into the company) and outflows (various expenses that the company has to meet). This is one of the tasks within the ambit of Financial Management.

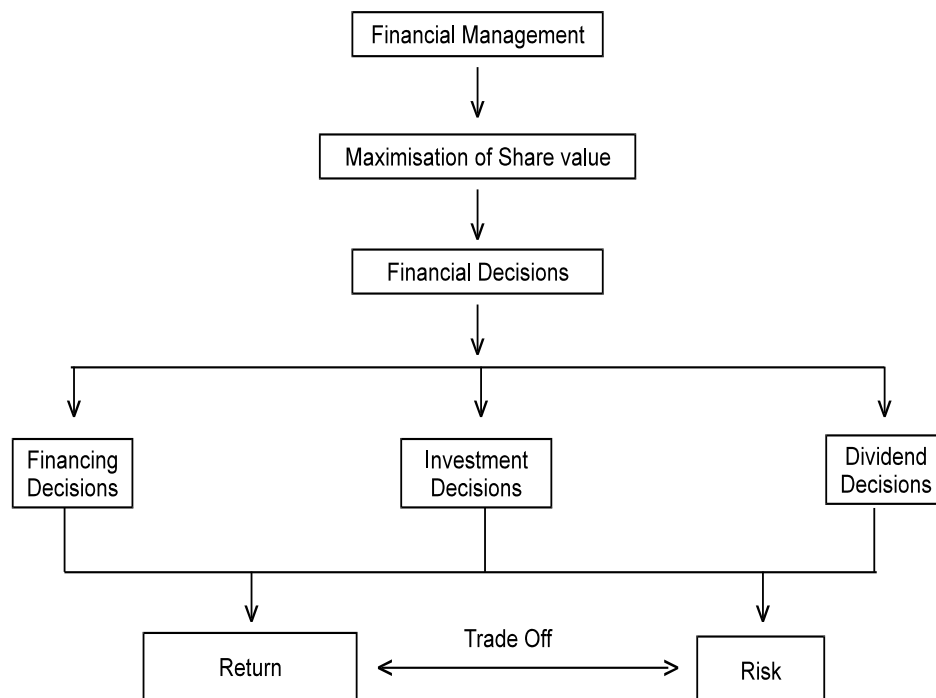
## 1.5 Scope of Financial Management

As an integral part of the overall management, financial management is mainly concerned with acquisition and use of funds by an organization. Based on financial management guru Ezra Solomon's concept of financial management, following aspects are taken up in detail under the study of financial management:

- (a) Determination of size of the enterprise and determination of rate of growth.
- (b) Determining the composition of assets of the enterprise.
- (c) Determining the mix of enterprise's financing i.e. consideration of level of debt to equity, etc.
- (d) Analysis, planning and control of financial affairs of the enterprise.

The scope of financial management has undergone changes over the years. Until the middle of this century, its scope was limited to procurement of funds under major events in the life of the enterprise such as promotion, expansion, merger, etc. In the modern times, the financial management includes besides procurement of funds, the three different kinds of decisions as well namely investment, financing and dividend. All the three types of decisions would be dealt in detail during the course of this chapter.

The given figure depicts the overview of the scope and functions of financial management. It also gives the interrelation between the market value, financial decisions and risk return trade off. The finance manager, in a bid to maximize shareholders' wealth, should strive to maximize returns in relation to the given risk; he should seek courses of actions that avoid unnecessary risks. To ensure maximum return, funds flowing in and out of the firm should be constantly monitored to assure that they are safeguarded and properly utilized.



**An Overview of Financial Management**

## 1.6 Objectives of Financial Management

Efficient financial management requires the existence of some objectives or goals because judgment as to whether or not a financial decision is efficient must be made in the light of some objective. Although various objectives are possible but we assume two objectives of financial management for elaborate discussion. These are:

**1.6.1 Profit Maximisation:** It has traditionally been argued that the primary objective of a company is to earn profit; hence the objective of financial management is also profit maximisation. This implies that the finance manager has to make his decisions in a manner so that the profits of the concern are maximised. Each alternative, therefore, is to be seen as to whether or not it gives maximum profit.

However, profit maximisation cannot be the sole objective of a company. It is at best a limited objective. If profit is given undue importance, a number of problems can arise. Some of these have been discussed below:

- (i) **The term profit is vague.** It does not clarify what exactly it means. It conveys a different meaning to different people. For example, profit may be in short term or long term period; it may be total profit or rate of profit etc.
- (ii) **Profit maximisation has to be attempted with a realisation of risks involved.** There is a direct relationship between risk and profit. Many risky propositions yield high profit. Higher the risk, higher is the possibility of profits. If profit maximisation is the only goal, then risk factor is altogether ignored. This implies that finance manager will accept highly risky proposals also, if they give high profits. In practice, however, risk is very important consideration and has to be balanced with the profit objective.
- (iii) **Profit maximisation as an objective does not take into account the time pattern of returns.** Proposal A may give a higher amount of profits as compared to proposal B, yet if the returns of proposal A begin to flow say 10 years later, proposal B may be preferred which may have lower overall profit but the returns flow is more early and quick.
- (iv) **Profit maximisation as an objective is too narrow.** It fails to take into account the social considerations as also the obligations to various interests of workers, consumers, society, as well as ethical trade practices. If these factors are ignored, a company cannot survive for long. Profit maximisation at the cost of social and moral obligations is a short sighted policy.

**1.6.2 Wealth / Value Maximisation:** We will first like to define what is Wealth / Value Maximization Model. The shareholder value maximization model holds that the primary goal of the firm is to maximize its market value and implies that business decisions should seek to increase the net present value of the economic profits of the firm.

Using Ezra Solomon's symbols and methods, the net present worth can be calculated as

shown below:

(i)  $W = V - C$

Where,

$W$  = Net present worth;

$V$  = Gross present worth;

$C$  = Investment (equity capital) required to acquire the asset or to purchase the course of action.

(ii)  $V = E/K$

Where,

$E$  = Size of future benefits available to the suppliers of the input capital;

$K$  = The capitalization (discount) rate reflecting the quality (certainty/uncertainty) and timing of benefit attached to  $E$ .

(iii)  $E = G - (M + T + I)$

Where,

$G$  = Average future flow of gross annual earnings expected from the course of action, before maintenance charges, taxes and interest and other prior charges like preference dividend;

$M$  = Average annual reinvestment required to maintain  $G$  at the projected level;

$T$  = Expected annual outflow on account of taxes;

$I$  = Expected flow of annual payments on account of interest, preference dividend and other prior charges.

(iv) The operational objective of financial management is the maximization of  $W$  in Point (i) above.

The  $W$  (Wealth) can also be expressed symbolically by a short-cut method as follows:-

$$W = A_1/(1+K) + A_2/(1+K) + \dots + A_n/(1+K) - C$$

Where,

$A_1, A_2, \dots, A_n$  represents the stream of cash flows expected to occur from a course of action over a period of time;

$K$  is the appropriate discount rate to measure risk and timing; and

$C$  is the initial outlay to acquire that asset or pursue the course of action.

Thus, it can be observed that the value/wealth maximization decision takes into consideration time value of money and uncertainty of risk.

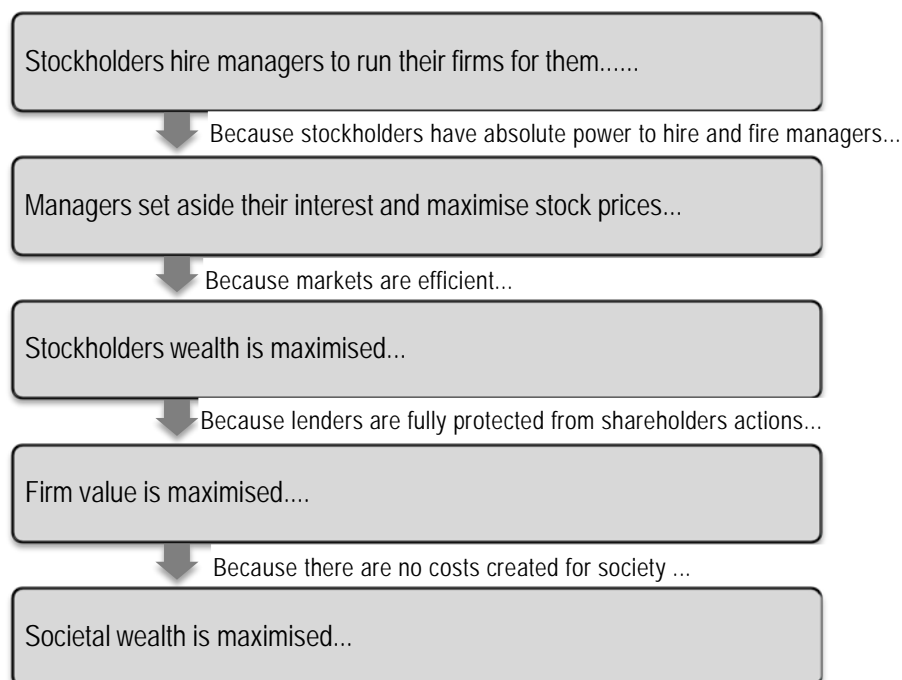
People buy the shares of a company as an investment with an expectation to gain from increase in wealth of the company. It means that they expect these shares to give them some

returns. It is the duty of the finance manager to see that the shareholders get good returns on the shares. Hence, the value of the share should increase in the share market.

The share value is affected by many things. If a company is able to make good sales and build a good name for itself, in the industry, the company's share value goes up. If the company makes a risky investment, people may lose confidence in the company and the share value will come down. So, this means that the finance manager has the power to influence decisions regarding finances of the company. The decisions should be such that the share value does not decrease. Thus, wealth or value maximization is the most important goal of financial management.

How do we measure the value/wealth of a firm?

*According to Van Horne, "Value of a firm is represented by the market price of the company's common stock. The market price of a firm's stock represents the focal judgment of all market participants as to what the value of the particular firm is. It takes into account present and prospective future earnings per share, the timing and risk of these earnings, the dividend policy of the firm and many other factors that bear upon the market price of the stock. The market price serves as a performance index or report card of the firm's progress. It indicates how well management is doing on behalf of stockholders."*



*Why Wealth Maximization Works?* Before we answer this question it is important to first understand and know what other goals a business enterprise may have. Some of the other goals a business enterprise may follow are:-

- Achieving a higher growth rate
- Attaining a larger market share
- Gaining leadership in the market in terms of products and technology
- Promoting employee welfare
- Increasing customer satisfaction
- Improving community life, supporting education and research, solving societal problems, etc.

Though, the above goals are important but the primary goal remains to be wealth maximization, as it is critical for the very existence of the business enterprise. If this goal is not met, public/institutions would lose confidence in the enterprise and will not invest further in the growth of the organization. If the growth of the organization is restricted than the other goals like community welfare will not get fulfilled.

To achieve wealth maximization, the finance manager has to take careful decision in respect of:

- (a) **Investment decisions:** These decisions relate to the selection of assets in which funds will be invested by a firm. Funds procured from different sources have to be invested in various kinds of assets. Long term funds are used in a project for various fixed assets and also for current assets. The investment of funds in a project has to be made after careful assessment of the various projects through capital budgeting. A part of long term funds is also to be kept for financing the working capital requirements. Asset management policies are to be laid down regarding various items of current assets. The inventory policy would be determined by the production manager and the finance manager keeping in view the requirement of production and the future price estimates of raw materials and the availability of funds.
- (b) **Financing decisions:** These decisions relate to acquiring the optimum finance to meet financial objectives and seeing that fixed and working capital are effectively managed. The financial manager needs to possess a good knowledge of the sources of available funds and their respective costs and needs to ensure that the company has a sound capital structure, i.e. a proper balance between equity capital and debt. Such managers also need to have a very clear understanding as to the difference between profit and cash flow, bearing in mind that profit is of little avail unless the organisation is adequately supported by cash to pay for assets and sustain the working capital cycle. Financing decisions also call for a good knowledge of evaluation of risk, e.g. excessive debt carried high risk for an organization's equity because of the priority rights of the lenders. A major area for risk-related decisions is in overseas trading, where an organisation is vulnerable to currency fluctuations, and the manager must be well aware of the various protective procedures such as hedging (it is a strategy designed to minimize, reduce or cancel out the risk in another investment) available to him. For example, someone who has a shop, takes care of the risk of the goods being destroyed by fire by hedging it via a fire insurance contract.



- (c) **Dividend decisions:** These decisions relate to the determination as to how much and how frequently cash can be paid out of the profits of an organisation as income for its owners/shareholders. The owner of any profit-making organization looks for reward for his investment in two ways, the growth of the capital invested and the cash paid out as income; for a sole trader this income would be termed as drawings and for a limited liability company the term is *dividends*.

The dividend decision thus has two elements – the amount to be paid out and the amount to be retained to support the growth of the organisation, the latter being also a financing decision; the level and regular growth of dividends represent a significant factor in determining a profit-making company's market value, i.e. the value placed on its shares by the stock market.

All three types of decisions are interrelated, the first two pertaining to any kind of organisation while the third relates only to profit-making organisations, thus it can be seen that financial management is of vital importance at every level of business activity, from a sole trader to the largest multinational corporation.

## 1.7 Conflicts in Profit versus Value Maximisation Principle

In any company, the management is the decision taking authority. As a normal tendency the management may pursue its own personal goals (profit maximization). But in an organization where there is a significant outside participation (shareholding, lenders etc.), the management may not be able to exclusively pursue its personal goals due to the constant supervision of the various stakeholders of the company-employees, creditors, customers, government, etc.

Every entity associated with the company will evaluate the performance of the management from the fulfillment of its own objective. The survival of the management will be threatened if the objective of any of the entities remains unfulfilled.

The wealth maximization objective is generally in accord with the interests of the various groups such as owners, employees, creditors and society, and thus, it may be consistent with the management objective of survival.

Owing to limitation (timing, social consideration etc.) in profit maximization, in today's real world situations which is uncertain and multi-period in nature, wealth maximization is a better objective. Where the time period is short and degree of uncertainty is not great, wealth maximization and profit maximization amount to essentially the same.

The table below highlights some of the advantages and disadvantages of both profit maximization and wealth maximization goals:-

Goal	Objective	Advantages	Disadvantages
Profit Maximization	Large amount of profits	(i) Easy to calculate profits (ii) Easy to determine the link between financial	(i) Emphasizes the short term gains (ii) Ignores risk or uncertainty (iii) Ignores the timing of

		decisions and profits.	(iv) Requires immediate resources.
Shareholders Wealth Maximisation	Highest market value of shares.	(i) Emphasizes the long term gains (ii) Recognises risk or uncertainty (iii) Recognises the timing of returns (iv) Considers shareholders' return.	(i) Offers no clear relationship between financial decisions and share price. (ii) Can lead to management anxiety and frustration.

**Example:** Profit maximization can be achieved in the short term at the expense of the long term goal, that is, wealth maximization. For example, a costly investment may experience losses in the short term but yield substantial profits in the long term. Also, a firm that wants to show a short term profit may, for example, postpone major repairs or replacement, although such postponement is likely to hurt its long term profitability.

Another example can be taken to understand why wealth maximization is a preferred objective than profit maximization.

**Illustration 1:** Profit maximization does not consider risk or uncertainty, whereas wealth maximization considers both risk and uncertainty. Suppose there are two products, X and Y, and their projected earnings over the next 5 years are as shown below:

Year	Product X	Product Y (₹)
1.	10,000	11,000
2.	10,000	11,000
3.	10,000	11,000
4.	10,000	11,000
5.	10,000	11,000
	50,000	55,000

A profit maximization approach would favour product Y over product X. However, if product Y is more risky than product X, then the decision is not as straightforward as the figures seem to indicate. It is important to realize that a trade-off exists between risk and return. Stockholders expect greater returns from investments of higher risk and vice-versa. To choose product Y, stockholders would demand a sufficiently large return to compensate for the comparatively greater level of risk.

## 1.8 Role of Chief Financial Officer (CFO)

Modern financial management has come a long way from the traditional corporate finance. As the economy is opening up and global resources are being tapped, the opportunities available

to finance managers virtually have no limits.

A new era has ushered during the recent years for chief financial officers. His role assumes significance in the present day context of liberalization, deregulation and globalisation.

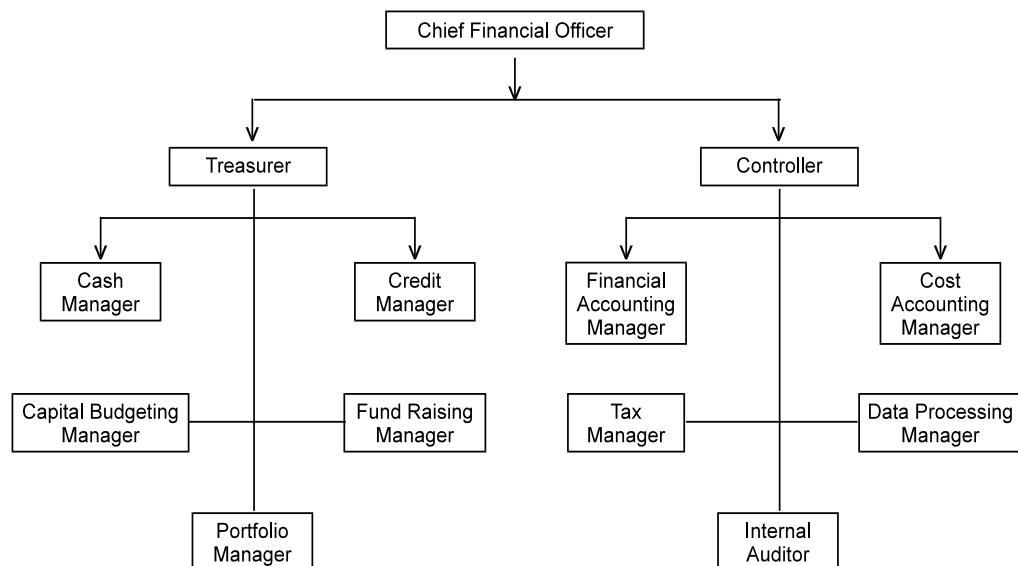
### Changing Role of the CFO

*"Today's CFO team is expected to add value well beyond the traditional roles of cost management, controls and acting as the conscience of the organisation. These roles are challenging enough, but today's CFO is expected to work in collaboration, by serving as the integration hub for key business processes, as a catalyst for change including business transformation, and as a consultant or trusted business advisor in helping to create sustainable growth." Jeff Thomson, IMA President and CEO*

To sum it up, the chief financial officer of an organisation plays an important role in the company's goals, policies, and financial success. His responsibilities include:

- (a) **Financial analysis and planning:** Determining the proper amount of funds to employ in the firm, i.e. designating the size of the firm and its rate of growth.
- (b) **Investment decisions:** The efficient allocation of funds to specific assets.
- (c) **Financing and capital structure decisions:** Raising funds on favourable terms as possible i.e. determining the composition of liabilities.
- (d) **Management of financial resources (such as working capital).**
- (e) **Risk management:** Protecting assets.

The figure below shows how the finance function in a large organization may be organized.



Organisation of Finance Function

**1.8.1 Role of CFO in today's World vis-a-vis in the past:** Today, the role of chief financial officer, or CFO, is no longer confined to accounting, financial reporting and risk management. It's about being a strategic business partner of the chief executive officer, or CEO. Some of the key differences that highlight the changing role of a CFO are as follows:-

What a CFO used to do?	What a CFO now does?
Budgeting Forecasting Accounting Treasury (cash management)  Preparing internal financial reports for management Preparing quarterly, annual filings for investors Tax filing Tracking accounts payable and accounts receivable Travel and entertainment expense management	Budgeting Forecasting Managing M&As Profitability analysis (for example, by customer or product) Pricing analysis  Decisions about outsourcing Overseeing the IT function Overseeing the HR function  Strategic planning (sometimes overseeing this function) Regulatory compliance Risk management

Emerging Issues/Priorities Affecting the Future Role of CFO
<ul style="list-style-type: none"> <li>➤ <b>Regulation:</b> Regulation requirements are increasing and CFOs have an increasingly personal stake in regulatory adherence.</li> <li>➤ <b>Globalisation:</b> The challenges of globalisation are creating a need for finance leaders to develop a finance function that works effectively on the global stage and that embraces diversity.</li> <li>➤ <b>Technology:</b> Technology is evolving very quickly, providing the potential for CFOs to reconfigure finance processes and drive business insight through 'big data' and analytics.</li> <li>➤ <b>Risk:</b> The nature of the risks that organisations face is changing, requiring more effective risk management approaches and increasingly CFOs have a role to play in ensuring an appropriate corporate ethos.</li> <li>➤ <b>Transformation:</b> There will be more pressure on CFOs to transform their finance functions to drive a better service to the business at zero cost impact.</li> </ul>

- **Stakeholder Management:** Stakeholder management and relationships will become important as increasingly CFOs become the face of the corporate brand.
- **Strategy:** There will be a greater role to play in strategy validation and execution, because the environment is more complex and quick changing, calling on the analytical skills CFOs can bring.
- **Reporting:** Reporting requirements will broaden and continue to be burdensome for CFOs.
- **Talent and Capability:** A brighter spotlight will shine on talent, capability and behaviours in the top finance role.

*Source: Report on ACCA-IMA Roundtable of Top CFOs on "The Changing Role of the CFO"*

## 1.9 Relationship of Financial Management with Related Disciplines

As an integral part of the overall management, financial management is not a totally independent area. It draws heavily on related disciplines and areas of study namely economics, accounting, production, marketing and quantitative methods. Even though these disciplines are inter-related, there are key differences among them. Some of the relationships are being discussed below:

**1.9.1 Financial Management and Accounting:** The relationship between financial management and accounting are closely related to the extent that accounting is an important input in financial decision making. In other words, accounting is a necessary input into the financial management function.

Financial accounting generates information relating to operations of the organisation. The outcome of accounting is the financial statements such as balance sheet, income statement, and the statement of changes in financial position. The information contained in these statements and reports helps the financial managers in gauging the past performance and future directions of the organisation.

Though financial management and accounting are closely related, still they differ in the treatment of funds and also with regards to decision making. Some of the differences are:-

### **Treatment of Funds**

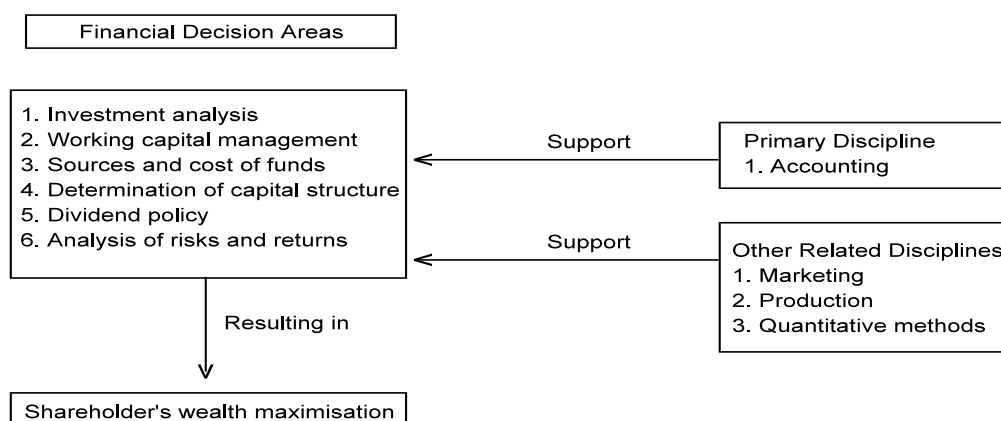
In accounting, the measurement of funds is based on the accrual principle i.e. revenue is recognised at the point of sale and not when collected and expenses are recognised when they are incurred rather than when actually paid. The accrual based accounting data do not reflect fully the financial conditions of the organisation. An organisation which has earned profit (sales less expenses) may said to be profitable in the accounting sense but it may not be able to meet its current obligations due to shortage of liquidity as a result of say, uncollectible receivables. Such an organisation will not survive regardless of its levels of profits. Whereas, the treatment of funds, in financial management is based on cash flows. The revenues are recognised only when cash is actually received (i.e. cash inflow) and expenses are recognised

on actual payment (i.e. cash outflow). This is so because the finance manager is concerned with maintaining solvency of the organisation by providing the cash flows necessary to satisfy its obligations and acquiring and financing the assets needed to achieve the goals of the organisation. Thus, cash flow based returns help financial managers to avoid insolvency and achieve desired financial goals.

### Decision – making

The purpose of accounting is to collect and present financial data on the past, present and future operations of the organization. The financial manager uses these data for financial decision making. It is not that the financial managers cannot collect data or accountants cannot make decisions. But the chief focus of an accountant is to collect data and present the data while the financial manager's primary responsibility relates to financial planning, controlling and decision making. Thus, in a way it can be stated that financial management begins where accounting ends.

**1.9.2 Financial Management and Other Related Disciplines:** For its day to day decision making process, financial management also draws on other related disciplines such as marketing, production and quantitative methods apart from accounting. For instance, financial managers should consider the impact of new product development and promotion plans made in marketing area since their plans will require capital outlays and have an impact on the projected cash flows. Likewise, changes in the production process may require capital expenditures which the financial managers must evaluate and finance. Finally, the tools and techniques of analysis developed in the quantitative methods discipline are helpful in analyzing complex financial management problems.



### Impact of Other Disciplines on Financial Management

The above figure depicts the relationship between financial management and supportive disciplines. The marketing, production and quantitative methods are, thus, only indirectly related to day to day decision making by financial managers and are supportive in nature while accounting is the primary discipline on which the financial manager draws considerably. Even

economics can also be considered as one of the major disciplines which help the financial manager to gain knowledge of what goes on in the world outside the business.

### SUMMARY

- Financial Management is concerned with efficient acquisition (financing) and allocation (investment in assets, working capital etc) of funds.
- In the modern times, the financial management includes besides procurement of funds, the three different kinds of decisions as well namely investment, financing and dividend.
- Out of the two objectives, profit maximization and wealth maximization, in today's real world situations which is uncertain and multi-period in nature, wealth maximization is a better objective.
- Today the role of chief financial officer, or CFO, is no longer confined to accounting, financial reporting and risk management. It's about being a strategic business partner of the chief executive officer.
- The relationship between financial management and accounting are closely related to the extent that accounting is an important input in financial decision making.